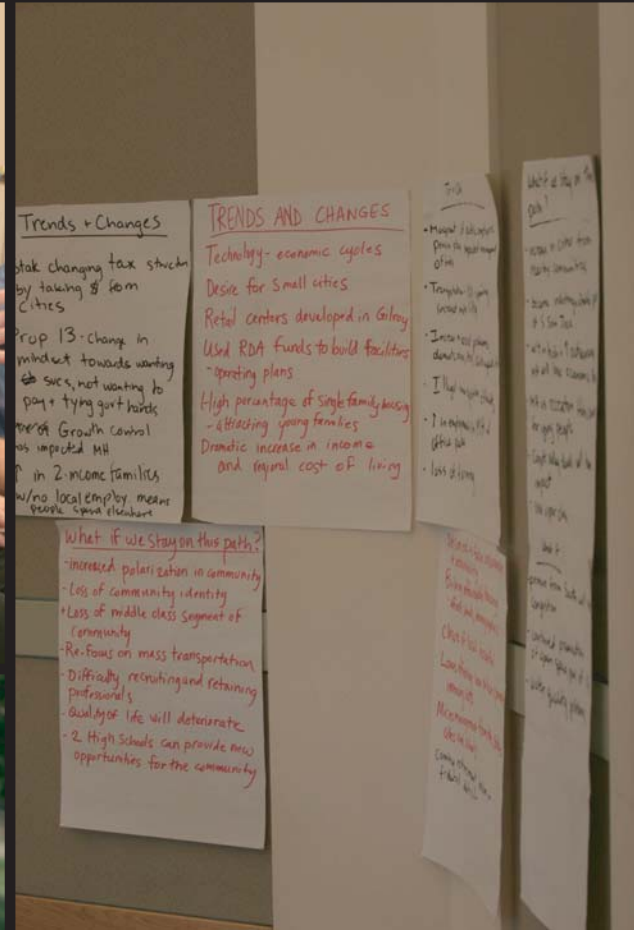


# Community Conversations



FISCAL YEAR 2006/07  
OPERATING AND CIP BUDGET





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# **City of Morgan Hill Fiscal Year 2006/07 Operating and CIP Budget**

## **Morgan Hill City Council**

Dennis Kennedy, Mayor  
Mark Grzan, Mayor Pro Tem  
Larry Carr, Councilmember  
Greg Sellers, Councilmember  
Steve Tate, Councilmember

J. Edward Tewes, City Manager  
Janet Kern, City Attorney  
Michael Roorda, City Treasurer  
Irma Torrez, City Clerk

## **Executive Team**

Jim Ashcraft, Director of Public Works  
Bruce Cumming, Chief of Police  
Jack Dilles, Director of Finance  
Melissa Stevenson Dile, Assistant to the City Manager  
Mary Kaye Fisher, Director of Human Resources  
Steve Rymer, Recreation & Community Services Director  
Irma Torrez, Council Services & Records Manager  
Garrett Toy, Director of Business Assistance and Housing Services  
Kathy Molloy Previsich, Director of Community Development

## **Finance Team**

Pat Heikens, Accounting Technician  
Isabel Jones, Accountant I  
Lourdes Reroma, Accountant I  
Tina Reza, Assistant Finance Director  
Angela Rivera, Accounting Assistant II  
Chu Thai, Budget Manager

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# GFOA Distinguished Budget Presentation Award



GOVERNMENT FINANCE OFFICERS ASSOCIATION

## *Distinguished Budget Presentation Award*

PRESENTED TO

**City of Morgan Hill  
California**

For the Fiscal Year Beginning

**July 1, 2005**

President

Executive Director

The Government Finance Officers Association of the United States and Canada (GFOA) presented a Distinguished Budget Presentation Award to the City of Morgan Hill, California for its annual budget for the fiscal year beginning July 1, 2005. In order to receive this award, a governmental unit must publish a budget document that meets program criteria as a policy document, as an operations guide, as a financial plan, and as a communications device.

This award is valid for a period of one year only. We believe our budget continues to conform to program requirements, and we are submitting it to GFOA to determine its eligibility for another award.











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CITY OF MORGAN HILL • FY 2006/07 • OPERATING AND CIP BUDGET



**CITY MANAGER'S OFFICE**

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MORGAN HILL, CA  
95037-7128

TEL: 408-779-7271

FAX: 408-779-1592

WWW.MORGAN-HILL.CA.GOV

**DATE: May 15, 2006**

**TO: City Council**

**SUBJECT: Fiscal Year 2006/07 Budget**

Dear Mayor and Members of the City Council:

I am pleased to submit the City Manager's Recommended Budget for Fiscal Year 2006/07. The Budget addresses community needs within the fiscal constraints. Again this year, General Fund revenues are insufficient to sustain prior levels of spending. It will be necessary to use reserves to balance the Budget. The comprehensive Budget for all funds reflects the City Council's commitment to long term financial planning, cost effective municipal services, and financial policies that recognize the need to fund future obligations.

The City Council adopted the Sustainable Budget Strategy in January 2004. The strategy required General Fund expenditure reductions of \$1.2 million and projected \$1.2 million in new revenues that were to be identified. By implementing the Sustainable Budget Strategy, it was projected that revenues would be brought into line with expenditures by June 30, 2008, so that deficit spending would disappear. In addition, the City Council adjusted the General Fund reserve requirement at that time to allow fund balance to be drawn down over the next several years while steps are taken to balance revenues and expenditures. The reserve requirement is still at a very safe level equal to 25% of estimated annual revenues. The City Council approved previous budgets which achieved ongoing expenditure reductions in excess of \$1 million annually. New revenue sources have not yet been identified. However, through a rebounding economy and the addition of new businesses in Morgan Hill, sales taxes and property taxes have increased substantially.

At the 2006 City Council Goal Setting Retreat, the Council set May 19, 2006, as the date to hold an all day workshop on budget issues and to begin deliberating the conclusions of the Community Conversations and their implications for major service reductions or new revenues. The results of the Community Conversations are presented in the Budget following this budget transmittal letter.

The Council also adopted the following policies:

- The City Manager's Proposed Budget for Fiscal Year 2006/07 should not exceed an operating deficit in the General Fund of \$1.6 million as included in the Five Year Forecast available at that time.
- Pending the results of the Community Conversations, the Council will maintain budget discipline in order to ensure operating results no worse off than shown in the Five Year Forecast.

The Budget proposes additional funding for 4 new positions, two of which are funded by the General Fund. Three of the new positions are necessary because of Centennial Recreation Center operations. Additional revenues were achieved in various funds through previously approved adjustments to community development processing fees and water fees, through inflationary adjustments to various fees, and through the first full year of collections for previously approved fire inspection fees. The Budget proposes staffing and operational costs associated with the start-up of the new Centennial Recreational Center, which the City plans to open in November 2006. It was necessary to use approximately \$800,000 from General Fund reserves in Fiscal Year 2006/07.

### **ECONOMIC AND DEMOGRAPHIC PROFILE**

The City of Morgan Hill provides a high quality residential community balanced with a significant industrial and commercial base. Population increased by 2.2% as of January 1, 2006, to a level of 37,091. The City provides a broad range of services, including police protection, development and housing, water and sanitation services, streets and parks construction, maintenance, planning, engineering, code enforcement, recreation,

# Budget Message (continued)

general city administration, and support services. The City has contracted with Santa Clara County to provide fire protection services and with South Valley Disposal and Recycling to provide solid waste collection services.

The goal of “economic development” is to encourage both the growth of the local economy and its diversification. Morgan Hill is part of a regional economy. Morgan Hill businesses import raw materials and labor. They export goods and services throughout the region and the world. Morgan Hill residents are employed throughout the region. Morgan Hill retailers serve both City residents and others in the region. Therefore, it is difficult to identify economic indicators that apply strictly to Morgan Hill. Nonetheless, the following four indicators are important to City government because they drive the revenues needed to support City services, and reflect “the business climate” in our portion of the larger region.

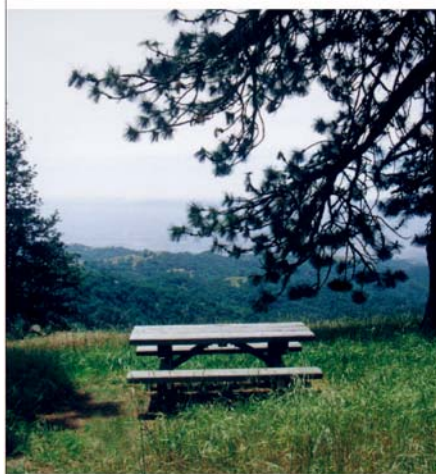
Retail sales: As a whole, taxable transactions in Morgan Hill increased, but not all business types have expanded. The composition of those transactions has changed, reflecting stagnation in “general retail sales” and a boom in transportation related sales taxes, based primarily upon vehicle sales and gasoline sales, which have increased to a level where they now represent 41% of all sales taxes received by the City.

Property valuation: The property tax base has consistently grown over the years. In some years, the increase was attributable to significant new construction in industrial and commercial property. Most recently, the growth is attributable to the construction of new homes and resale of existing residential property. For the tax year 2005/06, assessed valuation grew by more than 10% in the City.

Jobs: As measured by the number of jobs reported to the City through the business license tax process, the number of workers employed by the top 40 employers in the City increased by 2.3% from July 2004 to July 2005.

Hotel Occupancy: The hotels and motels of Morgan Hill are very dependent upon business travel. As measured by revenue from the Transient Occupancy Tax, these taxes have finally started to rebound from the recession and impacts of 9/11.

When the local economy slowed, beginning in 2000, the City’s policy of establishing prudent reserves proved to be critical. In response to the State’s weak financial position and the significant past revenue shifts from local government to the State, the voters passed Proposition 1A in November 2004. This measure limited the State’s ability to take new monies away from local government by requiring that the State meet certain requirements prior to taking money from local government and by requiring that any money taken be paid back to local government. The deal also allowed the State to take money from local



Comprised of more than 79,000 acres, Henry W. Coe State Park is the second largest state park in California and a popular spot for camping, backpacking, fishing, hiking, mountain biking, and horseback riding.



Morgan Hill provides the opportunity for year-round recreational activities including cycling, golfing and hot air ballooning.



Morgan Hill is expanding its community amenities to include a community center, aquatics center, library and recreational facilities.



# Budget Message (continued)

government in specified amounts in 2004/05 and 2005/06 only. For Morgan Hill, the State shifted, each year, \$343,000 in property taxes away from the General Fund and shifted \$2 million away from Redevelopment Agency property tax increment to the State's Educational Revenue Augmentation Fund. It appears that the State will not shift any additional tax dollars away from the City or Agency in the near future.

As projected for Fiscal Year 2005/06, sales tax revenue has grown by approximately 16% from the prior year to a level of approximately \$5.9 million, or 7% more than the peak of \$5.5 million received in 2000/01, primarily due to new businesses and modest economic growth. For Fiscal Year 2006/07, we are forecasting a new level of \$6.3 million in sales taxes. Transient occupancy tax revenue has increased by approximately 12% in Fiscal Year 2005/06, as projected, to a level of \$1,070,000, or 24% less than the peak of \$1.4 million received in Fiscal Year 2000/01. Growth of 3%, to a new level of \$1.1 million, is estimated for Fiscal Year 2005/06.

## BUDGET PROCESS

The Fiscal Year 2006/07 Budget is based upon an in-depth analysis of actual and projected fund balances, revenues, and expenditures. The City Manager gave each General Fund department an initial target based on the difference between departmental expenditures and departmental revenues. Departments were instructed to meet these targets through expenditure reductions and/or revenue increases. Each City department prepared line item detail for the department's activities and recommended certain service levels and activity goals for the 2006/07 budget year. The Finance Department prepared revenue projections with input from other departments. The City Manager then reviewed individual departmental requests, prioritized activities based upon City Council policy, and made certain adjustments. At the conclusion of this process, the proposed Budget was prepared, and it is being submitted to the City Council for review.

A cost allocation consultant prepared a new cost allocation plan for use in 2006/07. This plan will ensure that general administrative overhead is properly and reasonably distributed to all cost centers. Under the new plan, the General Fund will gain \$106,000 in additional revenues each year.

## BUDGET HEADLINES

- Complete construction of new Library
- Implement the Council's Sustainable Budget Strategy, considering feedback from "Community Conversations"
- Produce a work plan to amend the Redevelopment Plan which would increase the existing tax increment cap
- Develop Emergency Operations Center Public Information Officer function
- Complete construction of Centennial Recreation Center
- Open Centennial Recreation Center and implement partnership model with YMCA to operate this facility
- Study wastewater usage and connection fees and recommend rate changes
- Issue wastewater revenue bonds and determine timing of bond sales for future wastewater capital projects
- Issue \$3.6 million in lease revenue bonds to partially finance new Library construction
- Implement a website based on-line reporting system for minor crime occurrences
- Create short- and long-term strategic plans for Emergency Services
- Implement gang suppression strategy
- Complete Downtown Plan Update & implementation activities
- Aggressively deliver 5 year Capital Improvement Plan (CIP) of \$133 million
- Complete Zoning Ordinance revisions
- Complete Subdivision Ordinance update
- Complete Holiday Lake Estates Sewer Assessment District activities and annexation to City
- Adopt International Building Codes

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- Building Maintenance (Community Development Fund):*** It is proposed that the Community Development staffing be increased by a net two positions, comprised of the addition of one full-time Utility Worker II position and two half-time Custodian positions. The Utility Worker II position is needed to maintain the Centennial Recreation Center (CRC) pool equipment and the two custodians are needed to maintain the CRC and Police Facility buildings.

To finance the operations of the new Centennial Recreation Center (CRC), it will be necessary to transfer \$110,000 from the Community Centers Start-up Fund, as planned, and to use \$452,091 more from General Fund reserves in 2006/07. As use of the facility increases, it is expected that the net cost to the City in 2007/08 will be no greater than \$200,000 and that this operation will break even in 2008/09. The growth in revenues will come from membership fees. The CRC operations will be a cooperative venture with the YMCA of

# Budget Message (continued)

**Police (General Fund):** It is proposed that the Police Department staffing be increased by a net ½ position, comprised of the addition of one full-time OES Coordinator position offset by the deletion of ½ of a public safety dispatcher position. The cost of the OES Coordinator will be partially reimbursed by other funds through the City's cost allocation process.

The budget for 2006/07 includes the cost of negotiated increases for the miscellaneous employees (AFSCME) and the civilian employees of the police department (CSOA.) Increases for management and confidential employees are consistent with the scheduled July increases for those groups. The City has not yet completed negotiations with the police officers' union (POA). When a settlement is reached, it may be necessary to amend the budget to increase the use of General Fund reserves.

In light of the need to correct a significant structural budget deficit, the Council has directed us to focus on critical services first, and to minimize adverse impacts for the community and employees. The guiding principle has been to maintain current staffing and to increase staffing only where such additions are essential. An already "lean" organization has been challenged to deliver an ambitious work plan. We are proud of the accomplishments of the City's employees and their continued commitment to public and customer service.

The Community Conversations are a critical part of the Sustainable Budget Strategy. The input from the community will prove valuable as the Council determines the next steps. New revenues are needed just to preserve existing staffing levels. Additional staffing to address growing needs will require even higher levels of revenue.



Located at the southern edge of Silicon Valley, Morgan Hill offers businesses a campus-like atmosphere surrounded by hills, lakes and parks.



The roster of Silicon Valley companies that call Morgan Hill home is impressive and diverse.

That list includes: Abbott Labs, Anritsu, Ericsson, Specialized Bicycles, Fox Racing, Sakata Seed and Media Arts to name a few.

***For the proposed Fiscal Year 2006/07 Budget, the following specific steps were taken to keep the operating deficit to "only" \$800,000:***

- Transfer \$110,000 from the Community Centers Start-up Fund to the General Fund for Centennial Recreation Center start-up costs
- Continue the annual \$125,000 transfer from the Park Maintenance Fund to the General Fund
- Use approximately \$800,000 in General Fund reserves in 2006/07

***Following are steps that the City has taken in recent years to address the fiscal challenge:***

- Eliminated City funding for community events.
- Reduced expenditures for employee events, training, travel, conferences, and advertising
- Eliminated General Fund transfers to fund street repairs, affecting the quality of street maintenance.



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- In addition, the City has not addressed the following needs because of limited funding:*

# Budget Message (continued)

## FUND SUMMARIES

### GENERAL FUND

#### *Five Year Financial Plan Overview*

The City still faces the budget challenge that the local economy is not generating sufficient revenue to sustain current services on an ongoing basis. The City's costs, especially for employee benefits, have increased significantly primarily for reasons beyond the City's control.

Because the City has prudently built up financial reserves over the previous decade, Morgan Hill is in a position to carefully manage a response to this challenge without resorting to dramatic service level reductions or immediately increasing taxes.

However, unless there are long-term structural changes to bring the Budget into balance, the current level of spending on basic city services is not sustainable. Over the past four years, General Fund reserves have been used to balance the Budget. In Fiscal Year 2006/07 it will

be necessary to use \$800,000 in reserves even after previous aggressive expenditure reductions and after significant increases in sales tax and property tax receipts.

The fiscal squeeze is real, and it must be addressed if the community's priorities for services and governance are to be met. The City Council is responsible for establishing policies that meet community needs and lead to balanced budgets; and it is the responsibility of City staff to implement such policies in a manner that achieves the desired results, builds confidence, and prepares for the future. Fulfilling these responsibilities requires a strategy that will lead to financial sustainability.

For the Budget Strategy to be sustainable, it must provide for a "balance" of revenue and expenditures, while simultaneously maintaining an appropriate level of reserves.

The City Council therefore adopted a policy in January 2004 that reduced the target level of reserves to 25% of the General Fund revenues and planned for the Budget to be balanced by Fiscal Year 2007/08. That would allow for a gradual use of reserves while expenditures are reduced or revenues increased.

The two simultaneous budget targets allow for what we have called a "soft landing," but they do not eliminate the need for structural changes in the budget. For example, allowing a greater drawdown of reserves to 25% does not eliminate the need to modify the expenditure and revenue trends. Using a greater amount of reserves would allow the major decisions to be deferred or for structural changes to be implemented over a greater period of time, but the underlying problem is an imbalance between slow growing revenue and substantial cost increases.



Highway 101 runs directly through Morgan Hill and easily connects business centers throughout the Bay Area



Morgan Hill is just 30 minutes from San Jose International Airport, where new terminals, runways and roadways provide easy access and convenience to Silicon Valley travelers.

[illegible]

higher than originally estimated and because property taxes will be \$440,000 higher than originally estimated.

The budget for Fiscal Year 2006/07 estimates that total fund balance will further drop by another \$766,000 to \$8,566,671 as of June 30, 2007.

Revenues in Fiscal Year 2006/07 for the General Fund, including transfers in, are estimated to be \$22,116,684. This represents an 11% increase over the previous year's projected revenues, which is primarily related to revenues to be received from the new Centennial Recreation Center. Sales taxes and property taxes are estimated to increase by 6% and 10%, respectively. The higher increase in property taxes next year is attributed to the cessation of State revenue shifts that have occurred over the last couple of years. In general, the 2006/07 Budget estimates reflect a modest 3% growth for most General Fund revenues, as the local economy continues to recover.

Appropriations for Fiscal Year 2006/07, including transfers out, are \$22,882,679, which represents a 14% increase compared to the prior year original budget. Police and Fire budgets increased by a combined 5% next year. The Recreation budgets increased by a combined 58% because of the November 2006 opening of the Centennial Recreation Center. The other General Fund departmental budgets increased by a combined 11%, primarily because of a \$119,000 Elections increase associated with the November 2006 election, a \$101,000 increase in the City Attorney budget associated with current litigation, and the \$100,000 transfer out to the Community Centers Start-up Fund for future Outdoor Sports Complex costs.

Available fund balance as of June 30, 2006, is now projected to be \$9,332,666, including \$4,820,014 in required reserves. This includes the effect of a \$622,000 projected operating deficit for Fiscal Year 2005/06. The 2005/06 budget originally anticipated a \$1.3 million operating deficit. This deficit was reduced primarily because projected sales taxes for 2005/06 will be \$560,000

	FY 05/06	FY 06/07	FY 07/08	FY 08/09	FY 09/10	FY 10/11
Beginning Fund Balance	\$9.9	\$9.3	\$8.7	\$8.2	\$7.7	\$7.2
Add: Revenues	\$19.8	\$22.1	\$23.7	\$24.9	\$26.0	\$27.3
Less: Expenditures	(\$20.4)	(\$22.7)	(\$24.2)	(\$25.4)	(\$26.5)	(\$27.6)
<b>Ending Fund Balance</b>	<b>\$9.3</b>	<b>\$8.7</b>	<b>\$8.2</b>	<b>\$7.7</b>	<b>\$7.2</b>	<b>\$6.9</b>

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# Budget Message (continued)

Transfers out in Fiscal Year 2006/07 total \$406,239, including a \$289,239 transfer to the Police Facility Bond Debt Service Fund, a \$100,000 transfer to the Community Centers Start-up Fund to provide future start-up funds for the planned Outdoor Sports Complex, a \$10,000 transfer to the General Plan Update Fund for necessary expenditures, and a \$7,000 transfer to the Community Development Fund for the Coyote Valley Plan. The \$289,239 Police Facility debt service transfer from the General Fund includes approximately \$90,000 that represents the Police Impact Fund's share of this debt service. However, because the Police Impact Fund is not expected to have sufficient resources in 2006/07 to make its full share of the debt service payment, the General Fund will be providing this \$90,000. When the Police Impact Fund receives sufficient revenue in the future, as future development occurs, the General Fund will be repaid with interest calculated at the City's earnings rate.

In order to strategically plan for the future, it is appropriate for the City to explain the purpose of reserves. Based upon the City Council's established policy, a total of \$5,409,625 has been reserved within the General Fund as a general reserve for purposes that include economic uncertainty and emergencies. The reserve has been calculated as 25% of estimated 2006/07 revenues, excluding transfers in.

Most of the General Fund is committed to Public Safety. Police appropriations are \$9,185,196 and Fire appropriations are \$4,577,402, for a total of \$13,762,598. The total of these amounts accounts for 60% of General Fund appropriations. In the prior year, the original budget provided for a total Public Safety budget of \$13,135,561, which accounted for 66% of the total General Fund budget.

The remainder of the General Fund accounts for General Government operations (City Council, City Clerk, City Manager, Finance, Human Resources, and City Attorney), Park Maintenance and Recreation Services. A significant portion of the administrative cost is recovered in the form of charges to other City departments for services performed. Operating costs for the Community & Cultural Center, Aquatics Center, and new Centennial Recreation Center are reflected in the

General Fund, creating opportunities and commitments. It is anticipated these new ongoing financial commitments, high on the City Council's priorities, can be absorbed by the General Fund in the years to come. A schedule of revenues and expenditures for Recreation, including the Community and Cultural Center, Aquatics, and the Centennial Recreation Center, for the period 2003/04 through 2006/07, is included in the Supplemental Information section. For the Centennial Recreation Center in 2006/07, \$110,000 is proposed to be transferred from the Community Recreation Centers Start-up Fund to partially cover the start-up costs for this new facility.

The most significant sources of General Fund revenues for 2006/07 are:

- Sales Taxes of \$6,270,200, or 28% of total estimated revenues
- Property Taxes of \$5,478,305, or 25% of total estimated revenues
- Recreation Program Revenue of \$3,254,269, or 15% of total estimated revenues
- Reimbursement for General Administration Overhead of \$1,897,936, or 9% of total estimated revenues
- Transient Occupancy Taxes of \$1,102,100, or 5% of total estimated revenues
- Franchise Fees of \$1,039,752, or 5% of total estimated revenues

The following chart shows how much of the Fiscal Year 2006/07 General Fund budget is supported by discretionary general taxes and other revenues paid by residents and businesses. As shown below, all General Fund costs not recovered through departmental revenues (fees, grants, and reimbursements) are fully financed by discretionary revenues.

As shown, 71%, or \$16,249,113, of the \$22,882,679 General Fund budget is financed by discretionary revenues. In the prior year, the discretionary revenue budget equaled \$14,851,903, or 74% of total General Fund budgeted costs. Public safety accounts for \$12,735,427, or 78%, of total discretionary revenues.

# Budget Message (continued)

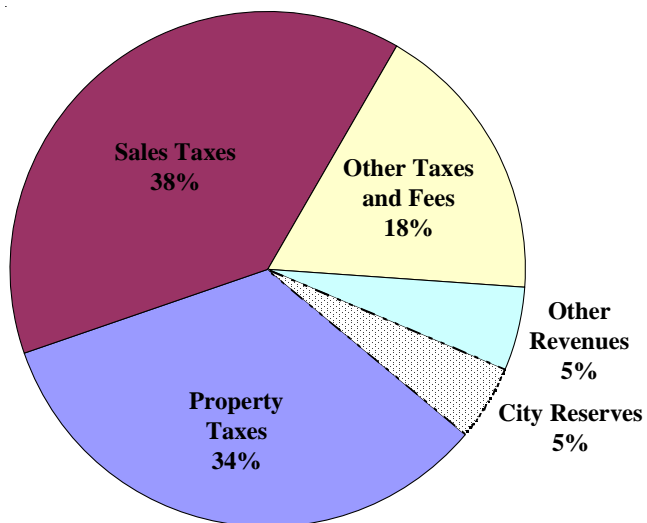
## FY 2006/07 GF Discretionary Support

Department	TOTAL COSTS	LESS DEPT REVENUES	LESS TRANSFER IN	NET COSTS	% OF TOTAL
City Council/City Clerk	\$ 722,895	\$ 439,142	-	\$ 283,753	1.7%
City Attorney	667,697	381,171	-	286,526	1.8%
City Manager/Comm & Marketing	440,986	223,272	-	217,714	1.3%
Recreation & Community Services	4,880,247	3,254,269	110,000	1,515,978	9.3%
Human Resources	511,411	252,833	-	258,578	1.6%
Finance	999,542	787,482	238,036	206,910	1.3%
Police	9,185,196	478,135	236,200	8,469,025	52.1%
Fire Administration	4,577,402	311,000	-	4,266,402	26.3%
Cable Television	40,272	28,076	-	12,196	0.1%
Park Maintenance	740,031	-	125,000	615,031	3.8%
Transfers Out	117,000	-	-	117,000	0.7%
<b>TOTALS</b>	<b>\$22,882,679</b>	<b>\$6,155,380</b>	<b>\$478,186</b>	<b>\$16,249,113</b>	<b>100.0%</b>

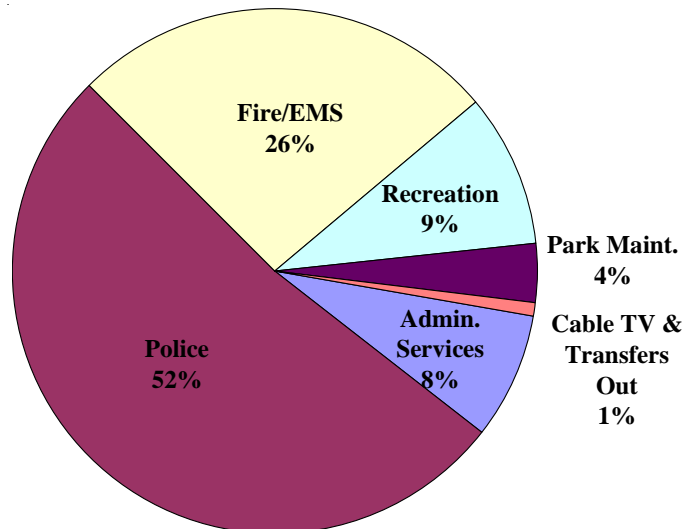
**FINANCED BY DISCRETIONARY REVENUES**

**\$16,249,113**

### Discretionary Revenues - \$16,249,113

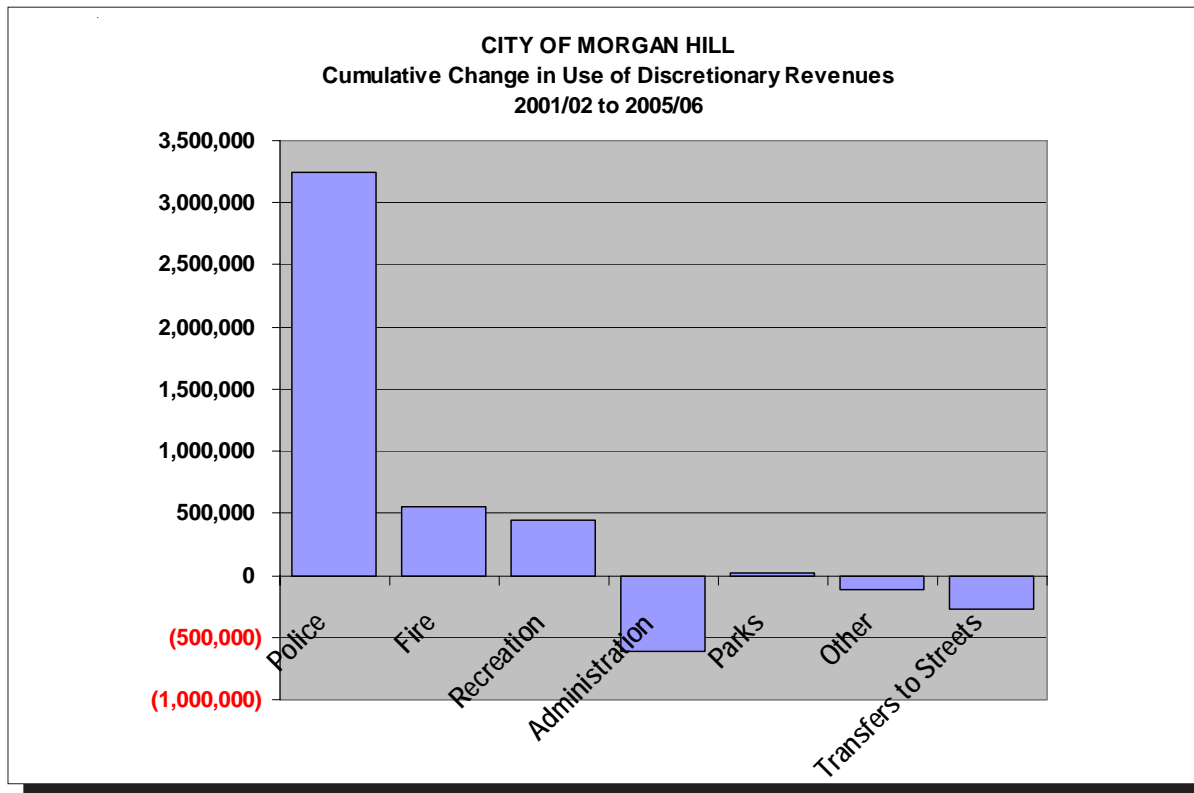


### Discretionary Expenditures - \$16,249,113





# Budget Message (continued)



The sources and uses of discretionary revenues are displayed in the following two pie charts. The first chart shows the major sources of discretionary revenues for Fiscal Year 2006/07. Together, sales taxes and property taxes make up \$11,748,505, or 72.3% of discretionary revenues. As reflected in this chart, \$765,995 of the discretionary revenues will come from General Fund reserves since proposed expenditures will exceed revenues in 2006/07. The second chart shows the uses of discretionary revenues for 2006/07, as described above.

Since the City has faced a structural deficit for four years, it is useful to see where the increase in the use of discretionary dollars has been spent. The following bar chart shows cumulative changes, totaling \$3.3 million dollars, in the use of General Fund discretionary dollars between Fiscal Years 2001/02 and 2005/06. The chart shows that the City has clearly spent most of the growth in discretionary dollars for public safety.

## COMMUNITY DEVELOPMENT FUNDS

The Community Development Fund is a special revenue fund used to account for services supporting private development activity. The fund is dependent upon the collection of planning, building, and engineering development fees to finance these costs. This year appropriations are \$3,519,714, which represents a 1% increase over the original prior year budget. Revenues in Fiscal Year 2006/07 are estimated to be \$3,381,294, or 12% more than prior year budgeted revenues. Proposed revenues for 2006/07 reflect increases in community development fees, previously approved by the City Council, which will be effective July 1, 2006, and which will reflect full cost recovery, as calculated by the City's fee consultant.

The General Plan Update Fund continues to provide the resources for the General Plan Update. The General Plan Update effort is critical for the City as it provides the basic policy blueprint on growth, development, and services. The costs associated with this activity are partially financed through a 5% surcharge on all building and planning permit fees.

# Budget Message (continued)

## STREET MAINTENANCE FUND

The Street Maintenance Fund is a special revenue fund used exclusively for street maintenance and traffic safety activities. Included are maintenance and repair of all roadways, streets, curbs, gutters, medians, roadway shoulders, and alleys; cleaning and repair of catch basins and storm drains; traffic engineering, safety studies and modifications, and related geographic information systems; street lighting and signal operations; and painting, marking, and striping. State gas tax funds that partially finance these activities are distributed based on population.

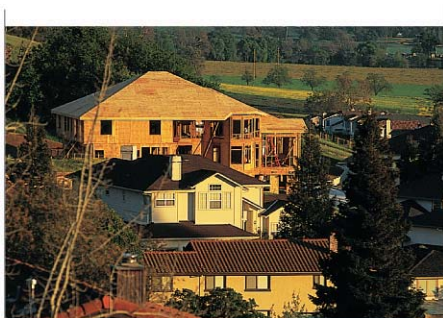
Revenues, including transfers in, are budgeted as \$2,862,640, including \$736,000 of Gas Tax funds, \$150,000 in transfers from the Environmental Programs Fund, \$1,323,000 in project grant funds, \$600,000 in transfers from utility funds, and \$53,000 in other revenue. While the General Fund transferred amounts into the Street Maintenance Fund in years prior to 2003/04, no funds have been transferred from the General Fund since and no funds are proposed to be transferred from the

General Fund in 2006/07, due to budgetary constraints. The \$150,000 transfer in from the Environmental Programs Fund reflects a \$50,000 increase from the prior year that is necessary to help maintain the City's streets. The lack of General Fund support and the fact that gas taxes received by the City do not increase with inflation threaten the City's ability to maintain streets in the future.

## PARK MAINTENANCE FUND

When the City Council established this fund, the Council planned to use it as an "endowment" fund for park maintenance and to pay for repairs and upgrades to existing parks. The interest received on the principal balance is to be appropriated strictly for maintenance of the City's parks. Revenues come from double park fees and from previous one-time general fund transfers of "excess" General Fund reserves. The interest revenue from this park maintenance "endowment" fund normally generates approximately \$100,000 per year in additional park maintenance funds that is used to pay for personnel in the Park Maintenance operation, so the City has historically budgeted a \$100,000

transfer to the General Fund each year. That amount was increased to \$125,000 in Fiscal Year 2004/05. The Budget proposes for Fiscal Year 2006/07 that the \$125,000 transfer be continued in order to assist in financing park maintenance costs that are paid from the General Fund. The Park Maintenance Fund Balance is projected to be approximately \$3.8 million as of June 30, 2006. This fund over time may resolve park maintenance concerns of City policy makers and residents.



As a growing residential community, Morgan Hill offers affordable housing including apartments, condominiums and single family homes.



Morgan Hill employers are served by skilled job seekers from more than six community colleges and world-class universities such as San Jose State, Santa Clara and Stanford.



Serving a diverse community, Morgan Hill schools are recognized for their achievements in innovation, dynamic partnerships, exceptional programs and support services.



# Budget Message (continued)

## SEWER AND WATER FUNDS

These are enterprise funds, where all costs incurred are covered by fees and charges paid by users of the systems. Presently, the City has approximately 12,000 accounts (including residential and business customers). The City water system meets or exceeds water quality standards. Budget details for these funds are found under the Public Works section of the budget document and are described as Water Operations and Sewer Operations. The Fiscal Year 2006/07 Water Operations budget reflects a rate increase of 2% scheduled to occur on January 1, 2007, but does not include a 5% rate surcharge increase that would result in a cumulative surcharge of 20%, scheduled to occur on the same date. Staff currently believes that the surcharge increase will not be necessary to pay for ongoing perchlorate related costs. The surcharge is necessary in order to cover the costs of monitoring and treating the water supply so that perchlorate contamination does not threaten the water supply. The Finance Director is required to report to the City Council as to the necessity of the rate and surcharge increases by September 30, 2006, prior to the scheduled January 2007 increases.

Both the Sewer Operations Fund budget of \$6,655,838 and the Water Operations Fund budget of \$8,736,136 are slightly less than the prior year original budgets if transfers to stabilization funds are not included. Sufficient fund balance, combined with estimated revenues, exists within each of these funds to fully finance these costs. In addition, the Fiscal Year 2006/07 Budget includes a planned \$400,000 transfer from the Water Operations Fund to the Water Stabilization Fund to restore reserves that had been previously depleted. The Wastewater Impact Fund budget includes the \$5.3 million cost of a new trunk line that is to be financed with bond proceeds from a new bond issue.

When the Council completed the comprehensive review of water rates in 2003, we indicated that it would be necessary to conduct a similar review for wastewater rates in the near future. The Budget and Work Plan call for a review of wastewater usage and connection fees in Fiscal year 2006/07. The level of spending for wastewater operations and maintenance is adequate for next year, but cannot be sustained without a rate adjustment in the future.

## INTERNAL SERVICE FUNDS

Internal Service funds are essentially responsibility centers within the City that provide services to other departments. These other departments are then charged for the portion of services provided to them by the respective internal service responsibility center. These funds include Equipment Replacement, Information Systems, Building Maintenance, Building Replacement, CIP Administration, Workers Compensation, Liability, and Unemployment Insurance. The Building Replacement Fund is a new fund that will be used to account for the reserves set aside to replace building components as needed.

## CAPITAL PROJECTS FUNDS

Total new capital projects are budgeted at \$37.1 million, as reflected in the CIP attached as an appendix. The capital projects budget is comprised of:

- Parks and Recreation projects totaling \$5,081,000
- Public Facilities projects totaling \$17,690,000
- Sanitary Sewer projects totaling \$6,451,000
- Streets projects totaling \$2,930,000
- Storm Drainage projects totaling \$2,730,000
- Water projects totaling \$2,205,000

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- Outdoor Sports Complex (\$2.8 million)
- Community Park Improvements Complex (\$1.0 million)
- Library (\$13.4 million)
- Centennial Recreation Center (\$3.4 million)
- Wastewater Trunk Line (\$5.4 million)
- Butterfield Detention Basin (\$1.9 million)
- New Well Property/Construction (\$1.0 million)

## APPROPRIATIONS LIMIT

## SUMMARY

I wish to acknowledge my appreciation to the members of the City Council for your continued support of programs that deliver necessary public services and for your sound fiscal policy. I also wish to express my appreciation to the talented and dedicated City staff, including Budget Manager Chu Thai, for their assistance in the development of this budget.

*[Handwritten signature]*

J. Edward Tewes  
City Manager

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At the capstone event, community leaders learned about the results of the Community Conversations. With the conclusions of the public in mind, they then worked through the same choices and alternatives presented to community members in the earlier dialogues with the addition of several ideas that showed support in the Community Conversations. Working in plenary sessions and small breakout groups, the community leaders became educated regarding the City's budget and anticipated deficit and examined the pros and cons of various approaches to eliminating the deficit. They considered alternatives for cutting services provided by the City and examined various revenue enhancements that could be adopted by the citizens of Morgan Hill through a ballot measure. As they worked to identify a set of acceptable steps, they considered three questions:

- At the end of the event, the leaders discussed the results of their dialogues and identified points of common ground on how to address the deficit.

- 1) The City's adopted and strongly supported growth controls
- 2) The limited nature of the local tax base, particularly the fact that the City has not developed as a large-scale retail destination (in contrast to the community of Gilroy)
- 3) The effects of Proposition 13
- 4) The lack of major local employers in Morgan Hill, which means most working adults commute to (and often spend money in) another community
- 5) Actions by the state government in the early 1990's (and again recently) which seized revenues intended for local cities
- 6) Commitments made to public employees in Morgan Hill (in particular health and pension benefits), which have increased the City's operating costs and future fiscal obligations
- 7) The loss of farms and agriculture in the community
- 8) Mandates that require setting aside a certain amount of new residential development as low-income housing
- 9) The impact of the "Dot.Com" era, which created a sense of "presumed prosperity" in Morgan Hill and was followed by an abrupt economic downturn

# Community Conversations

The leaders were then asked to visualize Morgan Hill ten years from now, if the existing trends continue. They cited the following possibilities for how Morgan Hill would develop in the future:

- 1) The community could become more polarized
- 2) Morgan Hill could be transformed into an “indistinguishable part of southern San Jose”
- 3) Morgan Hill could lose the distinctive character of its community
- 4) The City could have a smaller local economic base
- 5) The City could become re-focused and more reliant on mass transportation, as growing traffic congestion motivates citizens to stop relying on their own cars
- 6) It could become more difficult to recruit key types of service professionals (e.g. police, fire personnel, teachers, EMT worker)
- 7) Morgan Hill could evolve to become a regional recreational/youth hub

Based on the process of working through the choices facing Morgan Hill, the participants were asked at the end of the session to identify elements of common ground that had emerged from the dialogue. The community leaders identified and agreed to the following major areas of common ground:

- Generally speaking, the City government should focus on generating new revenues, rather than cutting services, in order to address its budget deficit.
- The City of Morgan Hill should rely upon a mix of new revenue sources to address its structural budget deficit.
- As part of this revenue mix, the City should work to add/develop a small number of additional car dealerships in the community because they generate such a substantial level of sales tax revenues.
- The City should keep its Redevelopment Authority, but should concentrate on basic infrastructure and creation of economic development opportunities.
- The City should seriously consider proposing a real estate transfer tax to generate new revenues to fund City services. Under State law, it would be necessary for the City to become a charter city for this to be possible.
- The City should also consider proposing a new tax or fee on development. This new tax/fee should be assessed on both residential and commercial development. However, the structure of this new tax/fee should take the issue of equity into account. For example, homes built for low- and moderate-income community residents might be exempted from a new development tax or a new set of fees if the additional cost would discourage developers and landowners from supplying these homes.